INTERNAL REVENUE SERVICE

July 10, 2000

Number: **2001-0001**
Release Date: 3/30/2001
UIL: 3121.04-00

The Honorable [redacted]
United States Senate
Washington, D.C. 20510

Attention: [redacted]

Dear Senator [redacted]:

This letter is in response to your inquiry dated May 24, 2000, about your constituent, [redacted]. [redacted] is concerned about the use of technical services firms ("body shops") to obtain the services of skilled technical workers–including nonimmigrant aliens holding H1-B visas.[1] [redacted] subchapter S corporation provides technical services in the capacity of an independent contractor. Service recipients are reluctant to contract directly with [redacted] because, under IRS requirements, he can be characterized as an employee of the service recipients.[2] Neither [redacted] nor the service recipients intend to establish an employment relationship; to the contrary, they want their independent contractor relationship to be valid for federal tax purposes.

The IRS Recognizes Independent Contractors like [redacted]

The Internal Revenue Service (IRS) recognizes the independent contractor relationship as a valid business arrangement. Businesses can hire either employees or

---

[1] The Immigration and Naturalization Service can give you more information on the H1-B visa program and eligible nonimmigrant aliens. [redacted] does not object to the use of H1-B workers but, rather, to their treatment as employees of the technical services firms and to his potential treatment as an employee of the service recipients.

[2] Service recipients contract with technical services firms for [redacted] services. However the technical services firms add an administrative charge of approximately 30% to the amount billed to the service recipient. Consequently, [redacted] services are considerably less expensive–and more competitive–when provided directly by his subchapter S corporation rather than through a technical services firm.

independent contractors. Thus, if an independent contractor relationship exists between [redacted] subchapter S corporation and a service recipient, the service recipient will not be treated as an employer. Conversely, if an employment relationship exists between a service recipient and a worker provided by a technical services firm, the service recipient will be characterized as an employer.

Common Law Rules Separate Employees from Independent Contractors

When determining a worker's status, the IRS applies common law rules to separate employees from independent contractors. Under the common law rules, treating a worker as an employee or an independent contractor originates from this definition: one party, the principal, is legally responsible for the acts or omissions of another party, the agent. Ultimately, an employment relationship depends on the principal's right to direct and control the agent.

The Decision Is Based on Who Directs and Controls

Following the common law rules, the tax regulations say an employer-employee relationship exists when the business for which the services are performed directs and controls the worker performing the services. The right to direct and control refers to both the result to be accomplished and the means by which that result is accomplished. Thus, an employee is subject to the control of the business both as to what will be done and as to how it will be done. The employer does not have to actually direct or control how the services are performed; it is sufficient if the business has the right to do so. If, however, an individual is subject to the control of another merely as to the result to be accomplished and not as to the means and methods for accomplishing the result, he is an independent contractor.

The IRS Considers All Relevant Facts

To determine if an individual is an employee or an independent contractor under the common law rules, the IRS examines all relevant facts. The IRS generally considers whether:

- There is a right to direct or control how the worker performs the specific task (behavioral control);
- There is a right to direct or control how the business aspects of the worker's activities are conducted (financial control); and
- The parties intend to create an employment relationship (relationship of the parties.)

If an employer-employee relationship exists, the designation of the employee as an independent contractor is disregarded.

The Corporate Form Applies to Federal and State Tax

Finally, provided that corporate formalities are followed and at least one non-tax business purpose exists, the corporate form is generally recognized for both federal and state tax purposes. Disregarding the corporate entity is an unusual remedy and is applied by most courts only in cases of clear abuse.

In summary, after considering all relevant facts and circumstances–including behavioral control, financial control, and the relationship of the parties–the IRS determines if an independent contractor relationship exists under the common law rules and will treat the parties accordingly for federal tax purposes. Similarly, if the IRS determines an employment relationship exists, the IRS will treat the parties as employer and employee. [redacted] can contract directly with service recipients as an independent contractor. He may want to show a copy of this letter to service recipients that are not sure how to make the distinction.

This letter will be made available for public inspection after names, addresses, and other identifying information have been deleted under the Freedom of Information Act.

I appreciate the opportunity to assist you with [redacted] employment tax questions and hope this information is helpful. If you or [redacted] has additional questions or if we may be of further assistance to you, please call me or [redacted] (ID #[redacted]) at (202) 622-6040.

Sincerely,

JERRY E. HOLMES
Chief, Employment Tax Branch 2
Office of Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Governmental Entities)